

August 16, 2000

LETTER 1305

THE PICTURE: I want to start this Letter with something very simple and basic – the pattern of the Dow. I wrote in the last Letter that the Dow has assumed the pattern of a rare "diamond pattern." The diamond, shown on this page, is just a variation of the well-known "head-and-shoulders" pattern, but instead of the usual "neckline" or support line, the diamond features a plunge below the neckline and then a rally back. This rally after the plunge makes up the right shoulder of the pattern.

The right shoulder has been forming ever since April. And you can see the Dow is still fluctuating within the boundaries of this huge, exotic diamond pattern.

I don't think we've seen the breakout of the pattern yet. A breakout would entail the Dow advancing above the most recent bearish trendline (A on chart) and then the Dow continuing to rally and finally testing or bettering its January 14 high of 11722.98.

That would be the happy resolution of the diamond pattern. However, most diamonds tend to be patterns of distribution. If this diamond turns out to be a distribution pattern then the Dow will turn down and break below the lower ascending trendline marked B on the chart. If that happens, it will suggest a very negative situation for the entire market.

But there's no point in playing soothsayer – there's no point in jumping the gun. We should get a resolution of the diamond pattern within a few months or even earlier. The Dow is still in the process of trying to decide.

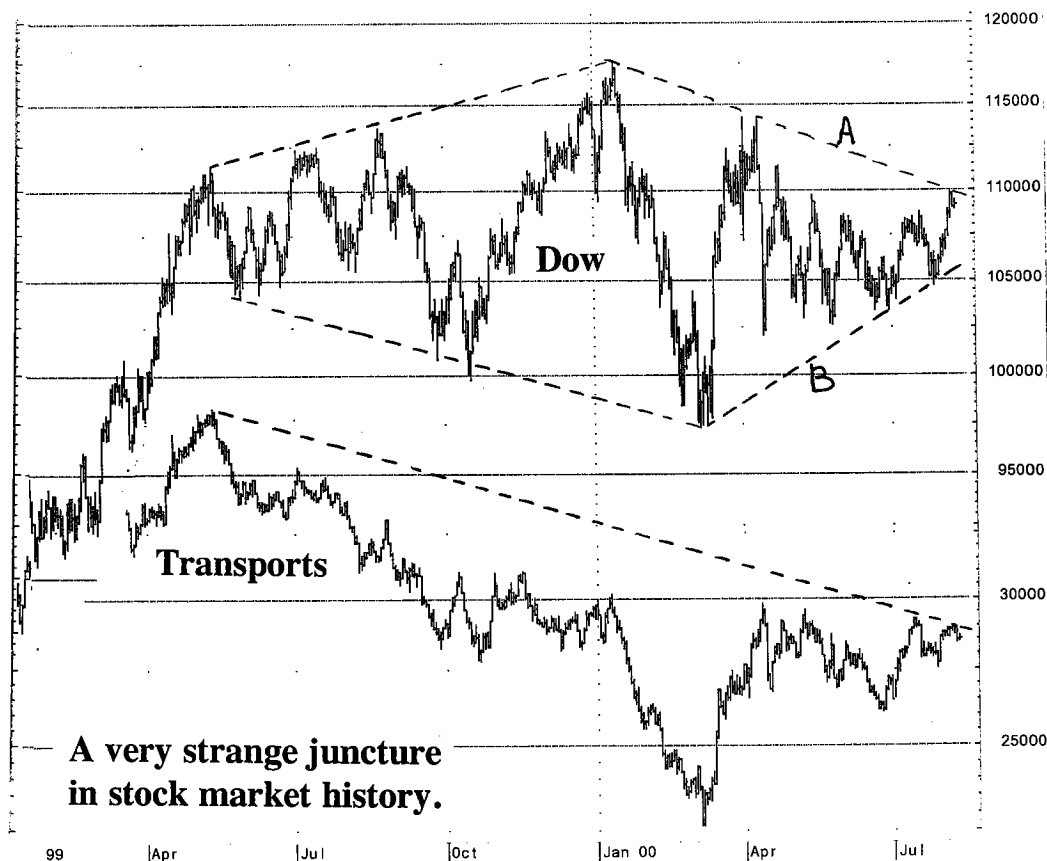
I want to emphasize that the above study plays no part in Dow Theory. Dow Theory

July 28, DJIA 10511.19; PTI 5145; A-D Ratio -6.32
Aug 4, DJIA 10767.75; PTI 5169; A-D Ratio -5.84
Aug 11, DJIA 11027.80; PTI 5187 ; A-D Ratio - 5.25
Dow Yield: 1.6%; Dow Price/Earnings: 20
Dow Times Book Value: 6.73%
Percentage of Undervalued Blue-chips: 17%
Gold 34-day MA: 285

does not deal with "fancy" patterns in the Averages. Dow Theory deals with values and trends and confirmations and non-confirmations.

Speaking of confirmations, the Transports are presenting a problem here. The April high for the Transportation Average was 2952.63. The May high for the Transportation Average was 2935.87. The July high for the Transports was 2919.04.

The Transports closed the most recent week at 2898.11. The Transports are not only failing to confirm the Dow, they are diverging (going in a different direction). This is always serious. It will be resolved either by the Transports gaining strength and rallying – or by the Dow losing strength and declining.



I have shown the Dow and the Transports together on ratio scale, and must say that as I look at this chart it presents a very unusual picture.

In the meantime, there is an irony here. The irony is that there are a lot of items that "suggest" that the Dow should be strong and heading higher. I'll list some of these positive items.

- (1) The bonds have been strong and the D-J Utility Average has advanced to new highs.
- (2) My PTI is in its bullish mode and the moving average of the PTI is rising.
- (3) The Dow is above its 200-day MA, which presently stands at 10785.
- (4) The Dow is above the 50% level of the January to March decline. The 50% level is 10759.
- (5) The market tends to be strong in the months prior to a presidential election.
- (6) MZM, the money supply that most closely correlates with the trend of the market, is continuing to rise on a trend basis, according to the St. Louis Fed chart.
- (7) The Fed is probably finished raising rates, at least this side of the election.

Of course, there is one other consideration, and it's a big one. I continue to believe that we are in a primary bear

market. In a bear market, the old rules tend to malfunction. Many of the techniques, rules and studies that worked in the bull market cease to work in a primary bear market.

As listed above, a good many studies suggest that the market "should" be moving higher. If it fails to move higher – you can blame it on the bear.

GETTING RICH: I doubt if anyone writing an advisory letter has written more about compounding than I have. I first learned about compounding from the retiring business editor of the old *New York Herald Tribune*. I honestly forget what year it was (I think it was back in the late '40s or early '50s). It was the last column that the editor wrote prior to retiring.

The editor wrote that "young people" make two major mistakes. The first mistake is that as soon as they get married, they buy a house and take out a mortgage. This means that they immediately go into debt. So instead of embarking on a long-term policy of saving money, they go the route of owing money. A major mistake.

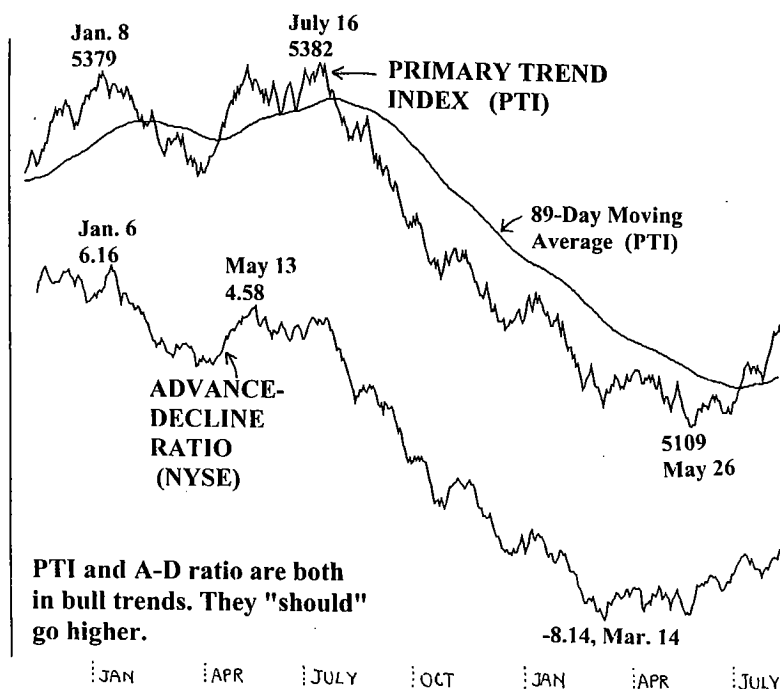
The second mistake that young people make is that they do not acquaint themselves with the great advantage of saving through time, and as a result they never understand or take advantage of the tremendous power of compounding.

The editor's editorial got me thinking. I immediately bought a book on the compounding tables. I call this book the book of the **future value of a dollar**. I studied the compounding tables carefully, and a light went on in my head. It was obvious -- compounding is the "safe, royal road to riches."

All of this is carefully explained in my site on the Internet under the title, "Rich Man, Poor Man." But question -- if compounding is the safe, royal road to riches, why doesn't everybody do it?

Ah, now we're getting into the laws of human nature. It's like asking, "If smoking is the road to cancer, why do 25% of all Americans still smoke?" Or if using narcotics leads to mental and physical trouble and very often trouble with the law, why do so many people use narcotics?" Or if 85% of day-traders end up losing money, why do thousands of people day-trade? Or if almost everybody loses at Las Vegas, how is it that the casinos are full day and night?

All the above, I believe, have to do with a strange process called **DENIAL**. Denial involves arrogance, ignorance and a process which I call "It won't happen to me." The smoker tells himself, "The other guy's going to get cancer, not



me." The day-trader tells himself, "The other guy may be a loser, but I can make money day-trading." The criminal tells himself, "The other sucker is going to get caught, but not me." Denial, denial, denial.

What about compounding? Here, I think, it's a matter of (1) greed, or wanting it all NOW, (2) A lack of discipline, and (3) refusing to sit down and understand just what compounding means, and understanding the power and advantage of compounding.

At any rate, I find it amazing that so many intelligent people fail to take advantage of compounding. Obviously the older you are, the less you will be able to use that power. But let's just say that this column is written for your children or your grandchildren.

I've drilled the concept of compounding into the heads of my own kids. You should probably do the same.

A second area that I want to discuss is the value or I should say the advantage of **income**. I know that it's fashionable these days to go for capital gains instead of dividends or interest. The only problem with this is that without dividends or interest you cannot compound. And here's the crux of it -- capital gains can be illusive; they are certainly not guaranteed. But compounding dividends and interest is something real, something sure. You're not depending on the market when you compound, you're depending on the law of mathematics.

As for capital gains, they can come and they can also disappear. Those who bought Cisco in February of '99 at 68 saw the stock rise to 81 $\frac{3}{4}$ a month later. But if they held it, they would just be breaking even (with no return on the investment) because Cisco is now selling at 65.

Compounding doesn't work that way. If you buy top-rated securities that pay say 6% or 7% in dividends or interest, you take in that 6% or 7% and reinvest it. After ten or 15 years what you originally paid for those securities doesn't matter any more. It doesn't matter because the compounding process has generated much more than the value of the original securities.

A third area that I want to discuss is the value of **tax-free income**. This can best be understood via this chart from the July 16 *Los Angeles Times*. For example, if you are married and have a joint taxable income of \$285,000 or more, a Cal muni yielding 5% is worth 11% to you as compared with a taxable security. In other words, you'd have to buy a security which throws off a dividend of 11% in order to equal the income from that 5% Cal muni bond. And question -- where are you going to find a decent security that throws off 11% in interest or dividends?

What Muni Yields Are Really Worth

Here's a look at what California municipal bond tax-free yields of 4%, 5% and 6% are truly worth to investors, by tax bracket. Example: If your combined (federal and state) effective tax rate is 37.4%, a 5% tax-free yield is the equivalent of earning an 8% fully taxable yield, such as on a corporate bond or a bank CD. The "effective" tax rates shown account for the deductibility of state taxes on federal returns.

Approx. joint taxable income	Approx. single taxable income	Federal + state tax rates	Combined effective tax rate	Taxable-equivalent yields of these Calif. tax-free yields:		
				4%	5%	6%
\$44,000 to						
to \$55,000		28% + 6%	32.3%	5.9%	7.4%	8.9%
\$55,000	\$26,000					
to \$69,000	to \$34,000	28% + 8%	33.8	6.0	7.6	9.1
\$69,000	\$34,000					
to \$105,000	to \$63,000	28% + 9.3%	34.7	6.1	7.7	9.2
\$105,000	\$63,000					
to \$159,000	to \$131,000	31% + 9.3%	37.4	6.4	8.0	9.6
\$159,000	\$131,000					
to \$285,000	to \$285,000	36% + 9.3%	42.0	6.9	8.6	10.4
\$285,000+	\$285,000+	39.6% + 9.3%	45.2	7.3	9.1	11.0

Sources: California Municipal Bond Advisor, Times research

Los Angeles Times

INVESTMENT POSITION:

This box is always written from the standpoint of the serious, longer-term investor. The PTI is now bullish, but from the big picture standpoint, the bear is still in the box.



This remains one of the trickiest markets I have dealt with in my 45 years of battling with markets. I remain of the opinion that it's just as easy to lose money in this market as it is to make it.

I've been advocating buying bonds (particularly muni bonds) and selected utility stocks, and I said that that's what I personally have done.

Both bonds and utilities have made major upside moves over the last few months, but if I had to first start spending my money now, I would still buy munis and selected utility stocks such as D, WEC, PEG, NSP, POM, TXU, SO.

The advance-decline line made up of operating companies only (no preferred, closed-end bond funds, etc.) has been flat since March, **meaning that as many stocks have declined as have risen**. It is very hard to make money in this type of very highly-selective market.

NOTES & QUOTES: The quality of corporate credit continued a two-year slide during the first half of 2000. And it isn't likely to end soon, stated Moody's Investor's

Service. Downgrades of companies' credit ratings swamped upgrades by a margin of 2 to 1 in the year 2000's first half. This is the highest ratio since the '91 recession. At the same time, debt levels of corporations relative to their net worth rose to their highest levels in seven years. Moreover, corporations are continuing to pile on debt at a furious rate.

Russell Comment: This is what I call bear market ammunition. During a prolonged downturn, debt can be a corporation's worst enemy. You can cut back costs in a recession, you can fire half your staff -- but the debt remains, and it must be serviced or repaid or you file for bankruptcy.

The plan that could swing the election: It's the California school-voucher plan. This is the initiative that would allow the state of California to give \$4,000 to any family that wants to send its kid to a private school rather than a public school (and this is regardless of the family's income). If this initiative passes (and I think it will), it will almost overnight radically transform education in the state of California.

This voucher promises to dominate the November elections in California, and it will probably draw record numbers of voters to the polls. The question: how will this initiative affect the votes of Bush and Gore in California? The candidates will almost surely have to take a position on this initiative. So the school voucher plan promises to be one of the most important issues in the November elections. Note: there are 6 million children in public schools in California. Every one of them would be eligible to apply for voucher money if the initiative passes. Furthermore, if the voucher passes how many other states will follow? Whew.

Speaking of analysts, the *NY Times* (July 30) featured an article on the sad demise of Amazon.com. AMZN's big believer, Blodget of Merrill, down-graded the stock from "buy" to "accumulate." Why did he down-grade it? Because AMZN saw its revenue for the quarter miss the estimate by \$7 million. Miss by \$7 million or from \$585 million to \$578 million? C'mon, that's why Blodget down-graded the stock. What scared Blodget and other lovers of AMZN was market action -- the stock has been falling apart.

The article noted that Mary Meeker, name analyst for Morgan Stanley, remains bullish on AMZN. I guess she has to -- after all, writes the *Times*, "Morgan Stanley may feel that bullish is the only way to be on Amazon, because it is the company's investment banker and likely to hold a barrel of the company's convertible bonds, which are tracking in the cellar. The firm is the major market maker in the debt. Ms. Meeker did not return phone calls."

Russell Comment: Disgusting. If I did something like this ten years ago the SEC would have me before their investigators and I would most likely be facing a big fine.

What I thought would happen to the e-tailers is now happening. The large, established retail outfits have gone on the Internet and are rapidly taking it over. As *USA Today* (July 31) put it, "Large companies were late catching on to the power of e-commerce. Now that they're hooked, all pure-play dot-coms can do is tread water as the big fish gobble up net dollars. Southwest Airlines sells more tickets on-line than pure on-line travel agent Travelocity. Internet-only Bluefly's revenue was about one-fifteenth of Spiegel's online revenue last year. And Wachovia Bank has more online customers than E-Trade Banks. So much for the first-mover advantage. Although dot-coms were first to tap the net, traditional firms are quickly, and silently, stealing away the lead.

Another example of what's happening is seen with Toys R Us. TOY is no longer the nation's top toy-seller. Guess who is? Why it's giant discounter, Wal-Mart, with its low, low prices and manageable inventory.

Do you ever feel badly about losses you've taken in the stock market? The following should make you feel better -- because these are real losses, historic losses. The champ is probably Yasuo Hamanaka. He lost \$2.6 billion over a period of ten years in unauthorized copper trading for Sumitomo Corp. Next might be Nick Leeson, who'll lose \$1.4 billion over three years trading the Nikkei 225 and bond futures for the Singapore office of Barings Investment bank.

You want more? Juan Pablo Davila lost \$299 million in 1994 trading copper for Codelco, a major Chilean copper firm. Then there's John Ho Park. He lost \$19.3 million in December of '98 trading German bond futures for Eurex.

I talk a lot about the power of compounding. How about the power of the double? Ask a friend if he'd rather have a million dollars today or if he'd rather start with a penny -- doubling it every day for a month or for 30 days. You may know that answer, but in case you don't, here are the figures.

Day	Balance
1	\$0.01
2	\$0.02
3	\$0.04
10	\$5.12
15	\$163.84
20	\$5,242.88
24	\$83,886.08
27	\$671,088.64
30	\$5,368,709.12
35	\$171,798,691.84
40	\$5,497,558,138.88
45	\$175,921,860,444.16
49	\$2,814,749,767,106.56

What, you grabbed the million? Big mistake. At the end of 30 days by the doubling route you'd have well over \$5

million. And at the end of 50 days you'd have \$2.8 trillion, or an amount half the size of the US national debt.

OK, that didn't work, and you still want to take your friend's money? Try this, bet him or her that they can't spell one of the nation's oldest services, the US Marshals Service. Yep, there's only one l and Marshals is plural, not possessive. The odds are heavy that you'll take your friend's money because almost everyone misspells the US Marshals Service (including most newspapers).

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There are three terrific channels on TV. They are the Discovery Channel, the public broadcasting channel (KPBS here in Calif.) and my favorite of all, the History Channel. The History Channel has been running a series on powerful men. I watched a segment last night. They talked about Vincent Astor, one of the world's wealthiest men at the time. Astor donated the money that started the great New York Public Library. Without the amazing facilities of the NY library I never could have started Dow Theory Letters.

Commodore Vanderbilt, another fabulously wealthy man, left all his money to his family, all except one million dollars which he gave to Central College in Tennessee. That gift became Vanderbilt University.

A third super-wealthy man was little Andrew Carnegie. He sold his giant steel business to J.P. Morgan for the then unheard of price of \$480 million. Carnegie said that it was "a disgrace to die with a lot of money." Carnegie established over 1,000 libraries in the US. He was a very short fellow, five foot three. Carnegie lowered all the doors in his home so that he would not "feel" that small.

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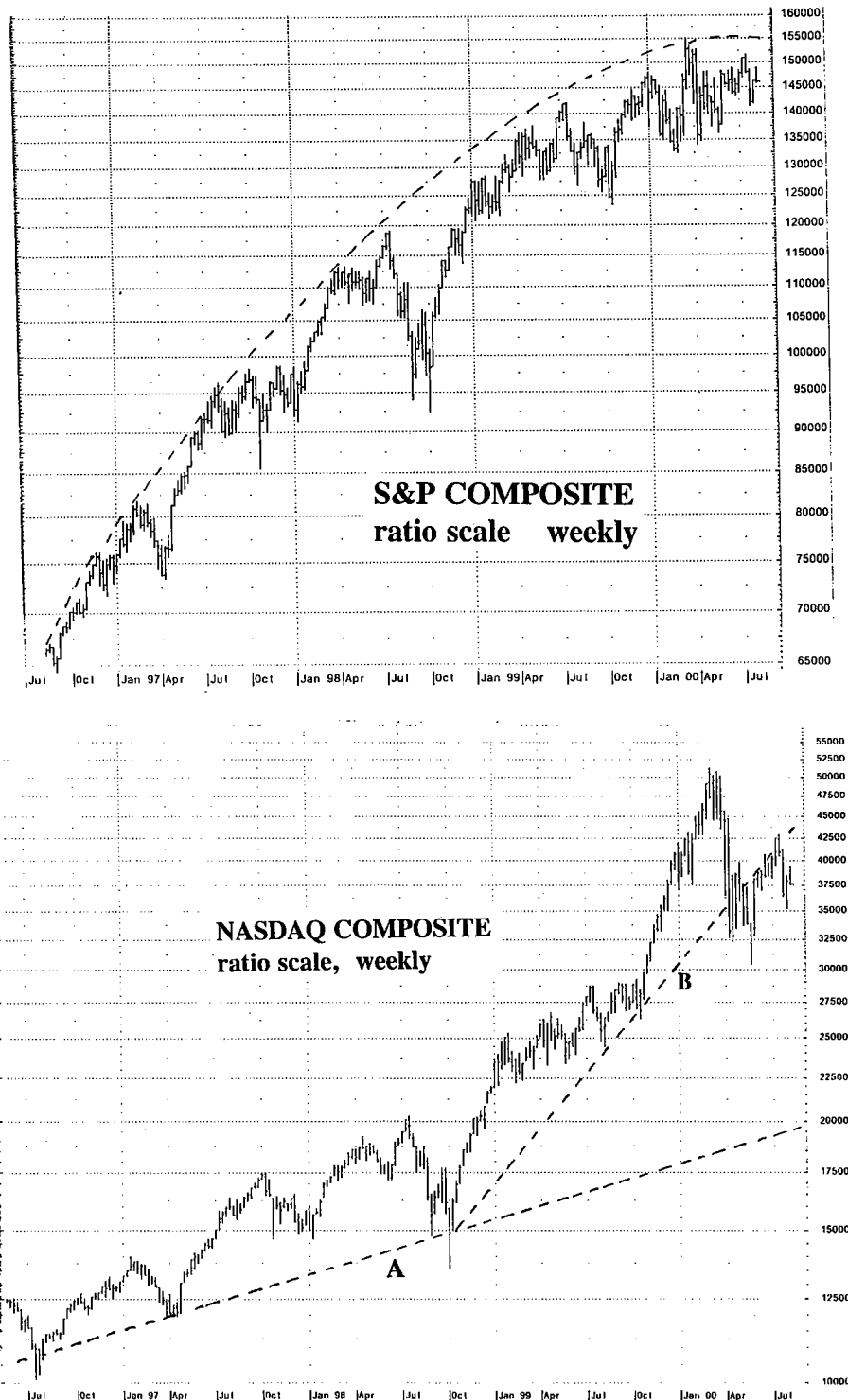
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S&P Composite: Just for the fun of it, I ran this semi-log chart of the S&P (weekly). Then I applied a French curve to the action, and here's what we see.

The S&P roared up from its low in July, 1997. But the S&P appears to be rolling over and more recently flattening out -- thus losing momentum. Once this loss of upside momentum occurs, it's very unusual for the item to regain its momentum again.

So the question now is whether the S&P will simply hold at a high level or whether it will break down. My guess is the latter.

A second chart shows a weekly (semi-log) chart of the Nasdaq. Here we see two trends. Trend A is fairly steep, and for a stock average it's very steep. But then came the wild ride, the frenzy, as seen on trend B. This trend, in my opinion, is clearly unsustainable. It was built on New Era sentiment, and some of the wildest speculation ever seen in the stock market.



My guess is that the Nasdaq is now in the process of topping out. The fatal move would be the Nasdaq breaking below 3000. A further guess is that we'll see that happening within a year or less.

In the meantime, we have what I've termed the "waterbed" market. Step on one area and another pops up. Step on the pop-up area and a third area pops up. What's happening is that money is not yet leaving this market. No, as one sector is hit, the money rushes to another sector and then a third sector in a mad quest to be in the right area and as quickly as possible.

PRIMARY TREND INDEX (PTI): Back in the '60s as technical analysis was becoming popular I noticed that the analysts tended to pile on to every new "hot indicator." There were the odd lots, the odd lot shorts, the "Confidence Index," the first hour index, the last hour index, the members' shorts, the public shorts – indicator after indicator gained wide popularity only to sink later into oblivion.

I decided that what I needed was an indicator that belonged only to me and my subscribers. And I needed an indicator that would be based totally on market action (since I didn't fully trust any other kind of observation or technique).

Through trial and error I worked through dozens of concepts and combinations. Finally, I developed an index which, through testing, I felt actually worked. I called this my Primary Trend Index or PTI.

The PTI was a composite of eight "action of the market" indices. I didn't see how the market could decline while the MAJORITY of these eight indicators were in a rising trend. And I didn't see how the market could rise if the MAJORITY of these eight indicators were in a declining trend.

I introduced the PTI in late 1971, and I've calculated and published the daily PTI figures ever since. As I said, on July 11, after being bearish for over a year, the PTI finally turned bullish again. So let's see where the PTI takes us – let's see how the stock market responds to the now-bullish PTI.

Question: Your PTI is now bullish, so why aren't you all-out bullish?

My answer boils down to two items. The first is that the Dow Theory says it's still a bear market. The second is VALUES. Stocks by any measurement are at their most expensive in history.

The PTI doesn't factor in values. It deals ONLY with direction. If you want to play direction, I have nothing

against that. Just understand what you're doing. The easiest way to play direction is with QQQ (Nasdaq 100) or SPY (S&P) or DIA (the Dow) all traded on the AMEX. If you want to buy any of these three, I'd advise using stop losses.

Remember, everybody makes mistakes, and everybody takes some losses. But the crucial mistake is to take the BIG HIT. Actual or mental stops, when speculating, will help you avoid the BIG HIT. Of course, even a stop loss won't guarantee that you'll get out at a decent price in the event of a sudden crash. A stop loss merely triggers a sell order when your item hits a certain number. A stop loss does **not** guarantee that you'll get out at your stop loss price.

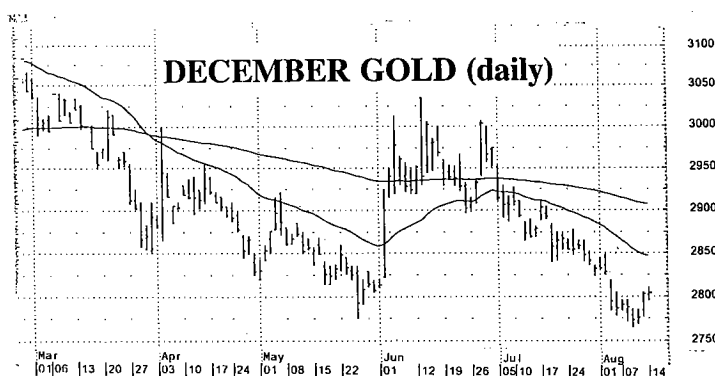
Note: The PTI turned bullish on July 11 – only a few weeks ago. If, and I say **IF** this is to be a major advance, then it's still early.

GOLD: The chart shows the active December contract. The low close for this contract struck was struck on August 9 at the embarrassingly low price of 277.30. The seems dirt cheap for gold, so let's discuss comparative values.

Do you remember in 1980 when the Dow bought just a single ounce of gold. At its price today, the Dow will buy 40 ounces of gold. One-to-one vs. 40-to-one. Yep, the times are a'changin'.

OK, let's concede that if gold was "expensive" in 1980, they're giving the yellow metal away today. That won't last, but when will it change? I wish I knew. But let's not depend on theories or ratios or forecasts. Let's depend on the dependable – which is another name for price action.

If gold is going to do something, the first thing it's got to do is move above its 34-day moving average. That MA stands at 284. You see it on the chart. The second or higher moving average is the 144-day MA, which stands at 291. So there you are gold-philes. There are the targets, there are the lines that gold must cross if the trend for gold is even beginning to turn.



NEXT MAILING: September 6, 2000